SET-OFF IN THE ADMINISTRATION OF INSOLVENT AND BANKRUPT ESTATES.

THE right of set-off has been extended in some instances in the English and American courts of bankruptcy further than the recognized rules of legal and equitable set-off seem to justify. We propose to examine two classes of cases in which courts of bankruptcy have apparently diverged from the equitable rule, and to inquire whether, under the present bankruptcy law, the precedents in these cases should be further followed.

An instance of the extended application of the doctrine of set-off in bankruptcy is found in the leading case of *Rose* v. *Hart*,[1] where the rule is laid down that a debtor to the bankrupt estate having in his possession property of the bankrupt with a present power of sale, though without a lien or other legal or equitable interest in the property, may after the bankruptcy sell the property and set off the proceeds against the debt.

This may be regarded as settled law in England,[2] and it is laid down by Judge Lowell as the law in this country under former statutes.[3] This rule has a somewhat remarkable history.

In 1748 a case, *In re Deeze*,[4] came before Lord Hardwicke, in which he referred for the first time to the words "mutual credits" introduced some years before into the bankruptcy law. These words were not found in the common law statute of set-off which was confined to "mutual debts." In the case before Lord Hardwicke as reported, a packer claimed to retain goods, not only for the price of packing them, but the sum of five hundred pounds lent to the bankrupt on his note, and the Chancellor decided that

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[1] 8 Taunt., 499; 2 Smith's Leading Cases, 10th Ed., 288.

[2] Robson's Bankruptcy, 10th Ed., 368; William's Bankruptcy, 7th Ed., 137.

[3] Lowell on Bankruptcy, § 256.

[4] 1 Atk. 228.

the packer might not only hold the goods for the amount of his lien, but also for the amount of the independent debt for which he had no lien, placing his decision upon the meaning of the words "mutual credits." Now, although the principle of set-off before its introduction by statute into bankruptcy, or at common law, had been applied in courts of equity, no case had then arisen or has since arisen in which set-off has been allowed in that court under circumstances similar to those which were before Lord Hardwicke, and his opinion as given by the reporter presents no argument in support of the extended meaning which he there appears to have given to the words of the statute.

Six years later the same question came before the same chancellor in *Ex parte Ockenden*,[1] apparently upon similar facts, but arising in a different trade. It then appeared that the earlier decision had been incorrectly reported and that evidence of a custom had been submitted in that case tending to establish a lien.[2] With this fact added, the Deeze case was transformed. It was merely the case of a lien upon the bankrupt's property and did not involve the right of set-off or the construction of the words "mutual credits." The Chancellor accordingly held that it did not afford authority for the decision of the case then before him in which no such evidence of custom was produced, and he accordingly disallowed the set-off for the reason that if it were permitted, a lien would be created when none had previously existed. Notwithstanding this decision, the earlier authority was followed in a line of cases.

Thus in *French* v. *Fenn*,[3] the bankrupt, Cox, was indebted to Fenn and had intrusted him with his interest in a string of pearls to sell and pay over his share of the profits. Fenn sold the pearls after Cox's bankruptcy, and Cox's assignee brought an action against Fenn for his share in the profits, to which Fenn set off the debt due from Cox. The set-off was allowed on the authority of *In re Deeze*, without reference to the later case of *Ex parte Ockenden*. So in *Parker* v. *Carter*,[4] where policies of insurance were

[1] 1 Atk., 235.
[2] See Lord Hardwicke's notes of the case printed in a note to *Young* v. *Bank of Bengal*, 1 Moore's P. C., 170.
[3] 1778, reported in Cooke's Bankruptcy Law, 5th Ed., 565.
[4] Cooke's Bankruptcy Law, 5th Ed., 580.

in the hands of a broker having no lien upon them, to whom the bankrupt was indebted, and a loss happened after the bankruptcy, the broker was permitted to set off his debt against the moneys collected by him on the policies, and in a similar case, *Olive* v. *Smith*,[1] in 1813, a like decision was reached. In neither of these cases was any reference made to the case of *Ex parte Ockenden*, and in *Olive* v. *Smith*, Lord Mansfield, commenting upon the authorities and upon the doctrine, made use of the following language:

"The case of *Parker* v. *Carter* runs upon all-fours with the present case. The cases of *French* v. *Fenn* and *Ex parte Prescott* are also prodigiously strong. Some of those cases seem to have gone further than the words of the statute would clearly warrant, and say that wherever there is a mutual trust the balance only shall be paid. I should have thought that the words of the statute meant only money transactions; but if the extension of mutual credit be, as it has been contended, a mistaken doctrine, the mistake is so deeply rooted, it having been again and again confirmed, that it would be rash indeed to overturn it; and there is a great deal of justice in the determination, at which, not only the Court of King's Bench, but the Court of Chancery, have arrived on this point. It would be nugatory to put this in a course of further discussion, when every Court should say that the point had been determined again and again: the rule therefore must be discharged."

Just what element of justice the eminent Chief Justice referred to can be inferred only from his use of the term "mutual trust" as implying that the loan had been made to the bankrupt in reliance upon the property left with the creditor as a means of payment. But the facts in the cases cited by him do not justify this assumption, and in the Deeze case it is recited that the goods were not delivered to the creditor until after the debt was incurred. In none of the cases is there reference to an understanding or agreement that the debt was to be paid out of the property, or the property applied to the payment of the debt. If such an agreement had existed, then the question would have been one of equitable or actual lien and in the absence of such an agreement, nothing seems to be added to the

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[1] 5 Taunt., 56.

thought by using the term "mutual trust" in place of "mutual credit."

Then came the leading case of *Rose* v. *Hart* (1818), before referred to. In that case the defendant was a fuller who had received cloth from the bankrupt to be dressed. At the date of the bankruptcy there was a debt due to the defendant for other cloth dressed for the bankrupt in addition to the work done upon the particular goods in the defendant's possession. The noticeable feature of the opinion in that case is the effort to reconcile the reported cases upon a common ground without considering the reasons upon which the rule itself could be supported.

Chief Justice Gibbs, after reviewing the decisions, said: "Whatever I think of the original decision, I could not persuade myself to break in upon a class of cases so long established, and if they could not be supported without carrying the doctrine found in *Ex parte Deeze* to its fullest extent, speaking for myself, I should be ready to follow it rather than to overturn all that has been settled upon this subject for such a length of time."

After examining the language of the statute he formulates a rule in the following language:

"Something more is certainly meant here by *mutual credits* than the words mutual debts import, and yet upon the final statement it is indicated merely that one debt shall be set against another. I think this shows that the legislature meant such credits only as must in their nature terminate in debts, as where * * * there is a debt on one side and a delivery of property with directions to turn it into money on the other; in such case the credit given by the delivery of the property must in its nature terminate in a debt, the balance will be taken on the two debts and the words of the statute will in all respects be complied with; but where there is a mere deposit of property without any authority to turn it into money, no debt can ever arise out of it, and therefore it is not a credit within the meaning of the statute."

In other words, the mere possession of the bankrupt's property with the power to convert it into money, although unaccompanied by any interest in the property by contract, or otherwise, is declared to be a credit existing at the time of the bankruptcy, because at some future time a sale may be made and the proceeds may be retained by the creditor and a debt thus created, which can be set off against a debt

to the bankrupt. I submit that this conclusion violates the rule of equality of distribution by conferring upon the possessor of the bankrupt's property a priority over general creditors to which he is not entitled by stipulation, or by any equity growing out of an enhancement of the value of the estate, or by any contribution to the estate which he has made in reliance upon the deposit of the property.

Rose v. *Hart*, although tracing its origin, as we have seen, to a misreported opinion, has remained an unquestioned authority in the English courts down to the present time; although there have not been wanting instances in which the courts have departed from the application of the rule while recognizing its authority.

The doctrine of that case was carried to its extreme length in *Easum* v. *Cato.*[1] The bankrupt shipped goods on his own account, but in the name of the defendant, his clerk, to whom he was indebted. The goods were sold by the merchant to whom they were shipped, and after notice of bankruptcy, he paid over the balance of the proceeds to the defendant, after deducting advances and charges. It was held that the defendant might retain such proceeds against the debt due to him from the bankrupt. It will be observed that the defendant did not have possession of the property at the time of the bankruptcy; he did not have the right to collect the proceeds as against the bankrupt, and, although the merchant was justified in paying them over to him, yet he received them merely as agent for the bankrupt, and, in retaining them, was guilty of a misappropriation. It was thought, however, that the mere possibility that the funds would be paid over to the defendant and retained by him, was a credit of which he was entitled to avail himself by way of set-off at the date of the bankruptcy.

The question then came before Lord Brougham in the Privy Council in the case of *Young* v. *The Bank of Bengal.*[2] It is not strange that a mind so accustomed to study precedents from the view-point of a parliamentary law reformer should have encountered extreme difficulty in reconciling the authorities upon this subject with an enlightened sense

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[1] 5 B. & Ald., 1861 (1822).

[2] 1836, 1 Moore, P. C., 150; 1 Deac., 622.

of justice. In fact he substantially overruled the previous decisions[1] although appearing to acquiesce in the rules laid down in *Rose* v. *Hart*. The case was this: Palmer & Co. had borrowed a large sum from the bank, pledging as collateral East India paper, with written authority to sell and apply on non-payment of the loan. They were also indebted to the bank on two promissory notes which were unsecured. Palmer & Co., becoming insolvent, the bank sold the collateral and realized a sum in excess of the loan, which excess they sought to set off against the bankrupt's indebtedness upon the unsecured notes. The set-off was not allowed. The former Chancellor reviewed all the authorities. He pointed out that an application of the securities for any purpose other than that for which they were specifically pledged, would amount to a breach of trust; that it was the duty of the assignee to pay off the loan for the purpose of realizing the surplus for the benefit of the general creditors and that his failure to do his duty ought not to prejudice the rights of the general creditors, and he emphasized the fact that the power of sale could not be exercized until after the bankruptcy, and that therefore no debt could arise against the bank until after the date of the bankruptcy, and that consequently there could be no mutuality of credits existing at that time.

Logically, this disposed of the rule in *Rose* v. *Hart*, for it demonstrated that there is want of mutuality necessarily in all instances in which the attempt is made to apply that rule. Judge Lowell regards this case as engrafting an exception upon the rule of *Rose* v. *Hart*. He calls attention to the statement of Baron Parke, who sat in the case, in an opinion given in the later case of *Alsager* v. *Currie*,[2] in which he explained that Lord Brougham's opinion went upon two grounds; that the deposit was for a particular purpose, and that the assignees were bound to redeem before default; and the eminent American jurist says that the true ground of decision was that the right to sell the bills, and, therefore, to convert the surplus into a debt did not arise in the time of the bankrupt, and the credit could not be created by the neglect of the assignees to redeem at

[1] See *Byles, J.*, in *Naorogi* v. *The Chartered Bank*, L. R., 3 C. P., 450.
[2] 12 M. & W., 750.

once.[1] He regards the case of the Bank of Bengal as limiting the doctrine of mutual credits to the case where the power of sale can be exercised at the time of the bankruptcy. He, however, fails, as it seems to me, to appreciate the full force of the objection of want of mutuality, for it is apparent that goods cannot form a part of an account as against money items, until they are reduced to money; and at the date of the bankruptcy, by the terms of the proposition in *Rose* v. *Hart*, the goods, with a power of sale stand upon one side of the account and the money debt upon the other.

It is, therefore, only by a constructive sale of the property that mutuality can be made to exist. But equity should not introduce the fiction of such constructive sale for the purpose of defeating the fundamental principle of equality of distribution which lies at the basis of the bankruptcy law. Hence, even after the goods have been sold equity should regard the proceeds as standing for the goods themselves, and so at no stage of the proceeding will the goods in the eye of the law, be commensurable with the money debt, and hence no mutuality can exist.

The English courts returned to the full force of the earlier decisions in the later cases of *Naorogi* v. *The Chartered Bank of India*,[2] and *Astley* v. *Gurney*,[3] although in the latter case,the facts appear to show a power of sale coupled with an interest.

The important point as to the mutuality of the claims which it is sought to set off, in the cases we are considering, is well illustrated in the case of *Ebberle's Hotels* v. *Jonas*[4] There the plaintiff, the liquidator of a company in course of winding up, had deposited cigars with the defendant as security for a debt; a small number of the cigars having been sold and the secured debt having been paid, the defendants claimed to hold the remainder of the cigars for a further debt due to him. The plaintiff brought detinue; the defendant pleaded set-off; but the set-off was not allowed. This case differs from some of the preceding

[1] Lowell on Bankruptcy, § 256.
[2] L. R., 3 C. P., 444.
[3] L. R., 4 C. P., 714.
[4] 18 Q. B. D., 459.

cases only in the circumstance that the cigars had not been sold. It was decided after the addition of the words "mutual dealings" to the section of the English Bankruptcy Law on set-offs, so that the words of the statute then read "mutual credits, mutual debts and other mutual dealings." The following extract from the opinion of Lord Justice Fry presents the question of mutuality with distinctness: "It seems plain on looking to the terms of that section[1] that, in order to be within it, the mutual dealings must be such as will result in an account in which sums due on one side may be set off against sums due on the other, and a balance struck. At the time with reference to which the question whether the section applies must be determined, the right of the plaintiff was to a return of the cigars in specie; and as has been already pointed out, it is impossible to bring into an account cigars on one side and a debt on the other, and to strike a balance between them. As matters stood when the point first arose, the terms were incommensurable."

If the cigars had been sold so that the liquidator had been put to his action for the proceeds, as debt or damages, the right of set-off would have existed under the rule in *Rose* v. *Hart*, which seems to demonstrate the unsubstantial character of the rule, since the mutual rights of the parties at the date of the bankruptcy are thus found to be determined by a subsequent change merely in the form of the property. A feeling of the injustice of this rule seems to have arisen in the mind of Mr. Justice Fry, for in the same opinion from which we have quoted, he said, after stating that the case turned on the form of the action:

"If we had taken a different view of the point on which our judgment turns, I think it would have been necessary very carefully to consider whether Section 38 applies to the case of a specific security given for a specific debt."

The doctrine of *Rose* v. *Hart* was fully approved and applied in the Court of Appeal in *Palmer* v. *Day*,[2] Lord Russell writing the opinion. The bankrupt had employed auctioneers to sell certain furniture and also to sell his house. They sold the furniture, but did not succeed in selling the house. The bankrupt sent them pictures which he had bought in at the furniture sale with instructions to

[1] Sec. 38 of the Bkptcy. Act of 1883–90.

[2] 1895, 2 Q. B., 618.

sell them at prices to be approved by him. He was adjudged bankrupt before the sale of the pictures and they were sold subsequently. The trustee brought an action to recover the proceeds against which the auctioneers set off the debt due to them from the bankrupt. The law of the case was stated as follows:

"The defendants were the depositories of the pictures with authority to sell them at approved prices and as auctioneers; they would certainly be entitled to receive for the pictures from the purchasers the amount realized. The authority could have been revoked, but until revoked the deposit with such authority to sell and receive the proceeds constitute, in our opinion, a giving of credit to the defendants. (See *Naorogi* v. *Chartered Bank*, approved in *Astley* v. *Gurney*, *ubi supra.*) There was a debt on one side and a delivery of property with directions to turn it into money on the other."

In *Elgood* v. *Harris*,[1] where the defendants, who were insurance brokers, undertook to set off against claims due to them from the bankrupt salvage which they had collected after the bankruptcy upon losses on policies settled before the bankruptcy, it was held that the set-off could not be allowed, since the moneys so received were part of the bankrupt's estate; the credits therefore were not mutual, the claim of the plaintiff for such salvage being one which first accrued to him as assignee of the bankrupt's estate, while the claim of the defendant was based on a credit given to the bankrupt himself. This case appears to be inconsistent with the recovery in *Easum* v. *Cato*, *supra*. The last reported case in England bearing on this subject is *In re Daintrey, ex parte Mant.*[2] There, however, although this subject is somewhat debated, the real question was the right to set off sums becoming due on a contract made before the bankruptcy, because contingent in character.

Turning now to the American cases, we shall find that they are few in number and none of them of controlling importance. The first case,[3] decided in 1804, arose under the Bankrupt Act of 1801. At that time *Rose* v. *Hart* had not been decided, and the authorities mainly relied upon by

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[1] 1892, 2 Q. B., 714.
[2] 1900, 1 Q. B. 546.
[3] Marks *v.* Barker, 1 Wash. C. C., 178.

counsel are those cited from Cooke's Bankruptcy, based, as we have seen, upon *In re Deeze*. The case was this: the plaintiff, as assignee in bankruptcy, brought the action to recover the proceeds of the bankrupt's property which the defendants had sold and upon which they claimed to have a lien for advances. It appeared, however, that the lien had been waived and the case was decided as one of set-off. The set-off was allowed, but without citation of authority and without exhaustive consideration. The question was, however, directly before Judge Lowell in *Ex parte Whiting, In re Dow*.[1] In that case it was held that a party who held stock of the bankrupt with a power of sale as collateral security for a certain debt, which was over-due at the commencement of the bankruptcy proceeding, upon exercising his power of sale after the bankruptcy, had a right to retain a surplus arising from the securities by way of set-off on another claim not secured by the collateral.

Judge Lowell there said: "This has been the law ever since the case of *Rose* v. *Hart*. Before that decision it" (the right of set-off) "was admitted even in cases where there was no power of sale. *Young* v. *Bank of Bengal* adds this limitation, and this only, that if the right to sell the pledge does not arise until after the bankruptcy, then there is no set-off for the surplus, for the reason that the assignee might redeem instantly before any power existed, and the creditors shall not be prejudiced by any failure of the right to redeem; or to put it in another way, that the rights of the parties are fixed at the date of the bankruptcy."

The plain result of this decision was to give the unsecured creditor, by reason of the bankruptcy, a security which he did not before have, in prejudice to the rights of the general creditors.

In *In re McVay*,[2] when the bankrupts had given to the creditor specific securities to cover two different transactions, he was permitted to apply a portion of the proceeds given to cover one debt upon a deficiency arising upon the other debt.

In *Catlin* v. *Foster*,[3] the assignee under a general assign-

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[1] 2 Low., 472, Fed. Cas., 17,573.

[2] 13 Fed. R., 443.

[3] 1 Saw., 37 Fed. Cas., 2519.

ment was permitted to set off, against his liability to a trustee in bankruptcy of the assignor subsequently appointed, the proceeds of assigned goods in his hands against moneys due to him for expenses incurred and services rendered as such assignee. The authority of *Rose* v. *Hart* is relied upon, but the essential element in that case which we have been considering was not present, since if the transactions under the general assignment constituted debts due to and from the bankrupts, it is plain that they were both due before the bankruptcy.

In *Ex parte Caylus*[1] the Court found that the creditor had by contract a lien upon the goods in his possession, although Judge Lowell in that case anticipated what he afterward held to be the law in *Ex parte Whiting, supra.*

The Supreme Court of Massachusetts declined to follow the rule adopted by Judge Lowell in *Ex parte Whiting, supra,* in a case where the question arose between a trustee under a general assignment and the debtor to the assignor,[2] and the same position was taken in a case in insolvency, *Tallman* v. *New Bedford Five Cent Savings Bank,*[3] although in *Hathaway* v. *Fall River Bank,*[4] the Court said, that if the property was unconditionally to be turned into money, the set-off might be allowed; it was held, however, that where goods were deposited to be sold only upon default, such right of sale did not constitute a credit, and the default not having occurred before the assignment, the set-off was not allowed.

Judge Holmes in the Brown case, above referred to, expresses a doubt as to whether the set-off should not be denied in a case such as that of *Ex parte Whiting,* for the reason that the proceeds of the securities after the payment of the secured debt are held by the debtor to the estate as a trustee, and that a liability growing out of that trust relation could not be brought into mutual account with the debt due to the debtor personally.

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[1] 1 Low., 550 Fed. Cas., 2534.

[2] *Brown* v. *New Bedford Inst. for Savings,* 137 Mass., 265.

[3] 138 Mass., 330.

[4] 131 Mass., 16.

The question has not been passed upon under the bankrupt law of 1898.[1]

Upon this review of the authorities, we are brought to a comparison of the reasons which may be given in support of and in opposition to the rule recognized by the cases. In support of the rule, it is suggested (1) that the words "mutual credits" ought to be given an extended meaning, because the trustee in bankruptcy takes subject to all equitable rights and defenses, and if no bankruptcy had taken place and the bankrupt's property held by the creditor had been sold, a case of set-off would have arisen, and (2) that there is a fair presumption that the possession of the property with an existing power of sale at the date of the bankruptcy arose out of the mutual confidence reposed by the parties respectively.

On the other hand, the arguments in opposition to the rule are these:

1. By the adjudication in bankruptcy the whole of the bankrupt's property is clothed with a trust for the equal benefit of all his creditors, and any equitable right or defense which would interfere with such equality of distribution must be such as would have been available at the moment of bankruptcy; otherwise, there is lacking the element of mutuality which is essential to set off, since the debt due to the insolvent estate is held in a trust relation, while the debt to the creditor is due individually.

2. The power of sale unaccompanied by an interest in the property is to be regarded as revoked by the bankruptcy, and its exercise thereafter is a wrong to the general body of the creditors which ought not to inure to the benefit of the wrongdoer.

3. Equity ought not to regard the property subject to the power of sale as reduced to money at the date of the bankruptcy, so as to work a mutuality of debts by equitable conversion in violation of the equity of equality under the bankrupt law.

Reduced to its last analysis the question turns upon the point whether the actual or constructive devolution of title to the property of the insolvent impresses it with such a

[1] See *In re Tacoma Shoe & Leather Co.*, 3 N. B. N., 9; *In re Meyer & Dickinson*, 3 N. B. N., 436.

trust for general creditors that rights of set-off, incomplete at that moment, should not thereafter be allowed. I submit that the property of the insolvent in the hands of a creditor of the estate is instantly, upon the devolution of title, impressed with such a trust, and, since the individual claim of the creditor stands in a different right, there is wanting the mutuality which is essential to the right of set-off.

If these views are correct, we may properly inquire whether, assuming the doctrine of *Rose* v. *Hart* to be the settled law in England, that rule should be adopted in this country under the present bankruptcy law.

It is true that where English statutes have been adopted into our legislation the known and settled construction of these statutes by the English courts has been considered as incorporated into the law and has been received with the weight of authority. That is true of the Statute of Frauds and the Statutes of Limitations.[1] But the bankruptcy statutes are peculiar at least in this, that they have been enacted at long intervals, during which the English law has been materially amended and its operation materially affected by the decisions of the courts. While, therefore, we may look to the English decisions as guides in construing the statute, it does not follow that in the use of a particular phrase Congress intended that it should have the meaning and the legal consequences attached to it by the English decisions at the date of its enactment by Congress.

We are justified in this position by the language employed by the Supreme Court of the United States in discussing the meaning of the words "mutual debts and mutual credits," under the late bankrupt law. Referring to the section of the Act of 1867 relating to set-off, Mr. Justice Miller, in *Sawyer* v. *Hoag*,[2] said:

"This section was not intended to enlarge the doctrine of set-off, or to enable a party to make a set-off in cases where the principles of legal or equitable set-off did not previously authorize it, the debts must be in the same right."

In *Libbey* v. *Hopkins*,[3] referring to the same section and

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[1] *Pennock* v. *Dialogue*, 2 Peters, 18; *McDonald* v. *Hovey*, 110 Wall., 630.

[2] 17 Wall., 610.

[3] 104 U. S., 306,

comparing it with that of the English bankruptcy law at the time of the decision of *Rose* v. *Hart*,[1] Mr. Justice Wood said:

"In our Act the terms 'credits' and 'debits' are used as correlative. What is debt on one side is a credit on the other, so that the term 'credits' can have no broader meaning than the term 'debts.' We find no warrant in the entire section or its context for extending the term credits so as to include trusts. Generally we know that 'credit' and 'trust' are not synonymous terms, they have distinct and well-settled meanings, and we see no reason why they should be confounded in interpreting the 20th Section of the Bankrupt Act."

In the case from which the former of these extracts is taken, the attempt was made to set off a debt due by an insolvent corporation to a stockholder against the demand of the Company upon the unpaid subscription of the creditor to the capital stock, and the Court held that no set-off could be allowed, because the debts were not due in the same right; that is, the debt due to the Company for capital stock was impressed with a trust in favor of the whole body of creditors, and, therefore, was in fact a debt due to their representative, whereas, the liability of the creditor was a debt of the Company.

In the case from which the latter quotation is made, moneys had been sent by the bankrupt to the creditor to be applied on account of a mortgage debt; the creditor had failed to so apply them and afterward sought to set them off against a general indebtedness. The Court held that the set-off could not be allowed for the same reason as in the former case, namely, that the debts were not due in the same right; the creditor, having agreed to apply the money on a specific debt, held it in trust for that purpose and could not, by a misapplication of it, create an obligation to his own advantage.

The case of *Sawyer* v. *Hoag*, *supra*, and other cases to the same effect,[2] proceed upon the theory that the unpaid capital stock of a corporation is a trust fund for the creditors.

[1] 2 George II, Chap. 2, Sec. 38.

[2] *Scoville* v. *Thayer*, 105 U. S. 143; *Scamor* v. *Kimball*, 92 U. S. 362; *Sanger* v. *Upton*, 91 U. S. 56; *Morgan* v. *Allen*, 103 U. S. 498; *In re* Troy Woolen Co., 8 N. B. R. 412; Fed. Cas., 14,203.

But, upon a declared insolvency, all the assets of an insolvent are also a trust fund for creditors.

In England, although on a winding up under the Companies' Act, a debt due to a stockholder cannot be set-off against his liability on unpaid capital stock, in bankruptcy such set-off is permitted.[1] So the Supreme Court has departed in this particular instance from the rule of set-off applied in the English bankruptcy cases. But this instance seems to be of a controlling character, since it places the denial of the set-off upon the trust arising from the declared insolvency, and thereby attaching to the assets of the insolvent.

We pass now to the consideration of another instance in which the doctrine of set-off is applied more extensively in bankruptcy than is permitted in courts of equity in many of the States. It is the rule in the State of New York, and in some other States, that where neither the debt due to nor the debt due from the insolvent has matured at the date of the insolvency, or where only the debt due to the insolvent has matured, no set-off will be allowed. But if the debt from the insolvent has matured, but the debt to the insolvent has not matured, a set off will be permitted.[2]

The equitable consideration which justifies the set-off, when the debt from the insolvent is due, arises from the fact that the debtor to the estate may waive the extended credit and regard the debt from himself to the insolvent as immediately due; and the debt to him being due, there arises the mutuality of obligation which lies at the basis of the doctrine of set-off.[3]

Equity, by compelling a set-off under such circumstances with the consent of the person entitled to the credit, when third persons are not injured, follows the law. But when the debt from the insolvent is not due, no such equitable considerations can be invoked to call for a departure

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[1] *In re Auriferous Properties, Lim.* (1898), 1 Chan. 691; *In re Duckworth*, L. R., 2 Ch. Ap., 578; *ex p. Strang*, L. R., 5 Ch. Ap. 492.

[2] *Fera* v. *Wickham*, 135 N. Y., 223; *Matter of Hatch*, 155 N. Y., 401; *Hughitt* v. *Hayes*, 136 N. Y., 163; *Richards* v. *La Tourette*, 119 N. Y., 54; *Rothschild* v. *Mack*, 115 N. Y., 1; *Bradley* v. *Angel*, 3 N. Y., 475.

[3] *Lindsay* v. *Jackson*, 2 Paige, 581; *Bradley* v. *Angel*, 3 N. Y., 475; *Richards* v. *La Tourette*, 119 N. Y., 54–59; *Fera* v. *Wickham*, 135 N. Y., 225.

from the rule at law. The doctrine as applied by the New York courts has the support of the decisions in many other States.[1]

But it has long been decided in bankruptcy that a set-off will be permitted where there are mutual debts, although one or both of them is not due until after bankruptcy. And when one debt is due, it has been held to be immaterial whether it was the debt from the bankrupt or the debt to the bankrupt. This rule had its origin in the case of *In re Prescot*,[2] decided by Lord Hardwicke in 1753. In that case the debt of the bankrupt on simple contract was due, but the creditor was indebted upon a bond which would not mature for several years. The set-off was allowed without discussion of the ground of decision, other than the statement that the bankrupt might be considered as giving credit in consideration of the bond. In the next reported case, by Lord Kenyon, in 1791,[3] neither debt was due, and the set-off was allowed upon the authority of *Ex parte Deeze* and *French* v. *Fenn*, *supra*.

In *Atkinson* v. *Elliott*,[4] before Lord Kenyon in 1791, there was some consideration of the subject. He said: "I agree to what was said by J. Buller in one of the cases, that where there is a trust between both parties, there is mutual credit." The word "trust" was there employed in the sense of confidence or credit. There was no evidence in that case which would support an express or implied understanding that one debt was to furnish the basis of credit for the other. The case was decided upon the authority of *Ex parte Prescot*, *supra*.

The rule thus became settled at an early date in England, without extended discussion or consideration as far as the reported cases show, and it has continued upon the authority of these cases down to the present time, so that now it may be regarded as unshakable. It is to be noted also that it does not appear from the reported cases that the distinction taken in the New York courts between the right of set-

[1] *Hamer* v. *Bank of Commerce*, 140 Mo., 225; *Spalding* v. *Backus*, 122 Mass., 553; *Chapman* v. *Bank*, 120 Pa. St., 86; *Oatman* v. *Batavian Bank* 77 Wis., 501.

[2] 1 Atk., 230.

[3] *Smith* v. *Hodson*, 4 T. R., 211.

[4] 7 T. R., 378.

off, as depending upon the maturity of debts due from and debts due to the insolvent, has ever been discussed.

In this country the English rule has been uniformly applied in bankruptcy.[1] The same rule has been adopted by the courts of a number of States in the administration of insolvent estates.[2]

In the Supreme Court of the United States the precise question here under consideration does not appear to have been determined. The principle of equitable set-offs has been frequently recognized and applied by that Court,[3] but the distinction drawn by the New York courts limiting the right of set-off to the case where the debt from the bankrupt has matured, does not seem to have been directly before the Court in any of the cases in which the right of set-off has been discussed.

The bankruptcy rule is vigorously supported in recent opinions in some of the State courts.[4] The contention is, that the trustee in bankruptcy, or the assignee, under a general assignment succeeds merely to the rights of the debtor, and that every legal or equitable remedy or defense of which a creditor might avail himself as against the debtor, should be equally available against his trustee or assignee. Hence, where the debt to the estate has not matured at the insolvency, the creditor ought not to be compelled to pay it except with the right of set-off, since he could not have been compelled to do so if the insolvency had not occurred. The equitable principle of equality of distribution is necessarily recognized, but it is said that the equity of equality should in such cases yield to the superior equity of the creditor entitled to the set-off.

The answer to this position is, that the reason for the

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[1] *In re City Bank*, 6 N. B. R., 71 Fed. Cas., 2742; *Drake* v. *Rollo*, 3 Biss., 273, Fed. Cas., 4066; *In re Kalter*, 2 N. B. N., 265, Loveland on Bankruptcy, § 123.

[2] *National Trust Co.* v. *Bank*, 91 Tenn., 336; *Kent Flower Co., Assignee*, v. *Bank*, 90 Ky., 225; *St. Paul & M. Trust Co.* v. *Leck*, 57 Minn., 87; *Thomas* v. *Exchange Bank*, 99 Iowa, 202; *Barber* v. *Bank*, 50 Ohio St., 90.

[3] *Carr* v. *Hamilton*, 129 U. S., p. 259; *Scott* v. *Armstrong*, 146 U. S., 499; *Yardley* v. *Philler*, 167 U. S., 344–360; see *Rolling Mills* v. *Ore & Steel Co.*, 152 U. S., 596, and cases cited, page 616.

[4] *National Trust Co.* v. *Bank*, 91 Tenn., 336; *St. Paul & M. Trust Co.* v. *Leck*, 57 Minn., 87.

transfer of title from an insolvent to his assignee or trustee is that the property of the debtor, by virtue of insolvency, has in equity become the property of his creditors. The assignee is primarily, by reason of the insolvency, the representative of the creditors. He takes the assets, to be sure, subject to all legal or equitable claims, rights and defenses which existed at the moment of the transfer of title, but unless the claim or defense was then available, it should not afterward become operative to the prejudice of the trust imposed upon the assets in favor of creditors by the declared insolvency. Hence the right of set-off, unless by such equitable considerations as are present, where the debt from the insolvent is due before the insolvency, should not be made available as against the superior equity of the general creditors.

It will be seen that, although the rule in *Rose* v. *Hart* is a more marked departure from the principle of equitable distribution than that in the later class of cases which we have been considering, the fundamental distinction is the same in both. The recognition of the trust relation resulting from a declared insolvency destroys the mutuality indispensable to the right of set-off in the cases we have been considering, and it seems that the tendency of the courts is toward a limitation of the rules of set-off which have been built upon the authority of *Rose* v. *Hart* and *Ex parte Prescot.*

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